

# KASNEB

## CIFA PART II SECTION 4

### EQUITY INVESTMENTS ANALYSIS

THURSDAY: 26 November 2015.

Time Allowed: 3 hours.

Answer ALL questions. Marks allocated to each question are shown at the end of the question. Show ALL your workings.

#### QUESTION ONE

- (a) Evaluate four elements that the financial analyst should consider when performing an industry analysis of a given company. (8 marks)
- (b) Pebbley Limited has a return on equity (ROE) of 6.4%. Its projected earnings per share (EPS) and dividend per share (DPS) are Sh.8 and Sh.3 respectively. The discount rate is assumed to be 8%.
- Required:**
- (i) Retention ratio. (2 marks)
- (ii) Sustainable growth rate. (2 marks)
- (iii) The value of the company's share. (2 marks)
- (c) Justify three reasons that could make companies in the same industry to have different price earnings (P/E) ratios. (6 marks)

(Total: 20 marks)

#### QUESTION TWO

- (a) (i) Among the most familiar and widely used valuation tools in equity valuation are price multiples. Justify why price multiples are used in equity valuation. (2 marks)
- (ii) Zawadi Designers Limited's shares are selling for Sh.25 per share. Earnings for the last 12 months were Sh.1 per share. The average trailing price earnings (P/E) ratio for firms in Zawadi Designers Limited's industry is 32 times.

**Required:**

Using the method of comparables, determine whether Zawadi Designers Limited's share is overvalued or undervalued. (2 marks)

- (b) Highlight two advantages of using the price-to-cash flow (P/CF) ratio as an equity valuation tool. (2 marks)
- (c) The following data was gathered by Ezekiel Rono, an equity analyst who researches for Redline Company:

|    |  |   |         |
|----|--|---|---------|
| 1. | Dividend payout ratio                    | = | 75%     |
| 2. | Return on equity (ROE)                   | = | 18%     |
| 3. | Earnings per share (EPS)                 | = | Sh.5.50 |
| 4. | Sales per share                          | = | Sh.350  |
| 5. | Expected earnings/dividends/sales growth | = | 4.5%    |
| 6. | Shareholders required rate of return     | = | 15%     |

**Required:**

The firm's justified price-to-sales (P/S) ratio multiple. (2 marks)

- (d) The following information is provided:

| Company        | Book value of equity 2014<br>Sh. "million" | Sales 2014<br>Sh. "million" | Shares outstanding 2014<br>Sh. "million" | Price<br>Sh. |
|----------------|--|-----------------------------|--|--------------|
| Mavuno Limited | 39,900                                     | 64,746                      | 12,324                                   | 62.74        |
| Ndovu Limited  | 122,040                                    | 64,374                      | 21,542                                   | 51.26        |

| Peer Group                     | Mean                | Median              | Mean                                    | Median                                  |
|--------------------------------|---------------------|---------------------|---|---|
|                                | Price-to-book (P/B) | Price-to-book (P/B) | Price-to-sale (P/S) Sales Sh. "million" | Price-to-sale (P/S) Sales Sh. "million" |
| Pharmaceuticals                | 11.244              | 8.50                | 17.416                                  | 9.06                                    |
| Computer applications software | 8.20                | 4.28                | 6.84                                    | 2.88                                    |

Mavuno Limited belongs to the pharmaceuticals group and Ndovu Limited belongs to the computer applications software group.

**Required:**

- (i) The current price-to-book (P/B) ratio for each company. (4 marks)
  - (ii) The current price-to-sales (P/S) ratio for each company. (4 marks)
  - (iii) Determine whether the share is overvalued, fairly valued or undervalued for each company based on the results obtained in (d) (i) and (ii) above. (4 marks)
- (Total: 20 marks)**

**QUESTION THREE**

- (a) Distinguish between a "firm's free cash flow" and a "free cash flow to equity". (4 marks)
- (b) The following information is available for Mapambo Limited:

|                     |               |
|---------------------|---------------|
| Capital expenditure | Sh.20 million |
| Corporate tax rate  | 30%           |
| Debt repayment      | Sh.23 million |
| Depreciation charge | Sh.10 million |

**Income statement:**

|                         |                      |
|-------------------------|----------------------|
|                         | <b>Sh. "million"</b> |
| Sales                   | 650                  |
| Less: Cost of sales     | <u>(438)</u>         |
|                         | 212                  |
| Operating expenses      | <u>(107.5)</u>       |
|                         | 104.5                |
| Less: Interest expenses | <u>(8)</u>           |
| Earnings before tax     | 96.5                 |
| Less: Tax               | <u>(28.95)</u>       |
| Net income              | <u>67.55</u>         |

**Required:**

- (i) Free cash flow to equity. (4 marks)
  - (ii) Free cash flow to the firm. (4 marks)
  - (c) Summarise four advantages and four challenges of technical analysis. (8 marks)
- (Total: 20 marks)**

**QUESTION FOUR**

- (a) The following information relates to Wageni Ltd.:

1. The company reported before tax operating income of Sh.21 million for the year ended 31 December 2014. This was after charging Sh.4 million for development and launch cost of a new product that is expected to generate profits for 4 years.
2. The company has a risk adjusted weighted average cost of capital (WACC) of 12%.
3. The company is paying interest at a rate of 9% per annum on a substantial long-term loan. The interest is not charged as expense in the operating income in note 1 above.
4. The company's non-current assets value is Sh.50 million.
5. The net current assets have a value of Sh.22 million.
6. The replacement cost of the non-current assets is estimated to be Sh.64 million.
7. Corporate tax rate is 30%.

**Required:**

- (i) The company's economic value added (EVA). (6 marks)
- (ii) The company's residual income (RI). (4 marks)
- (iii) Comment on the results obtained in (a) (i) and (ii) above. (2 marks)

(b) The following information relates to Platinum Limited, a private firm:

|    |  |                 |
|----|--|-----------------|
| 1. | Working capital balance                      | = Sh.4,000,000  |
| 2. | Fair value of fixed assets                   | = Sh.11,000,000 |
| 3. | Book value of fixed assets                   | = Sh.8,000,000  |
| 4. | Normalised earnings of firm                  | = Sh.2,000,000  |
| 5. | Required rate of return on working capital   | = 5 per cent    |
| 6. | Required rate of return on fixed assets      | = 8 per cent    |
| 7. | Required rate of return on intangible assets | = 15 per cent   |
| 8. | Weighted average cost of capital             | = 10 per cent   |
| 9. | Long-term growth rate of residual income     | = 5 per cent    |

**Required:**

Using the excess earnings method (EEM), determine:

- (i) The value of intangible assets for Platinum Limited. (4 marks)  
(ii) The market value of invested capital. (2 marks)

(c) Describe two steps of the top-down approach of equity valuation. (2 marks)  
**(Total: 20 marks)**

**QUESTION FIVE**

(a) An investment analyst plays a critical role in collecting, organising and communicating corporate information and to some extent recommending appropriate investment action based on sound analysis.

In relation to the above statement, describe six features of an effective research report. (6 marks)

(b) The following information relates to Golden Star Limited, a company quoted at the PAQUA Securities Exchange:

1. The current market price per share is Sh.28.27.
2. The most recent quarterly dividend per share is Sh.0.2.
3. Over the coming year, two more quarterly dividends of Sh.0.20 are expected, followed by two quarterly dividends of Sh.0.22 per share.
4. The company has a required rate of return on equity of 9.5%.
5. The target price per share is Sh.32 over the one year period.

**Required:**

- (i) One-year expected return of the company. (3 marks)  
(ii) The target price if the company is fairly valued. Ignore returns from reinvesting the quarterly dividends. (3 marks)

(c) (i) The following information relates to Zelion Limited:

1. Current market price per share Sh.36.
2. Last dividend paid Sh.2.40.
3. Required rate of return 12%.
4. The dividends are expected to grow at a constant rate in the foreseeable future.

**Required:**

The expected share price 5 years from now. (4 marks)

(ii) Discuss two strengths of the two stage dividend discount model (DDM) compared to the constant growth dividend discount model.

(4 marks)

**(Total: 20 marks)**

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